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RUEHML/AMEMBASSY MANILA 3018
RUEHBUL/AMEMBASSY KABUL 9224
RUEHNE/AMEMBASSY NEW DELHI 3860
RUEHLO/AMEMBASSY LONDON 8828
RUEHKP/AMCONSUL KARACHI 0425
RUEHLH/AMCONSUL LAHORE 6165
RUEHPW/AMCONSUL PESHAWAR 4995
RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL
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SUBJECT: WITH RECORD HIGH Q1 BORROWING FROM THE STATE BANK, PAKISTAN
SLIPS CLOSER TOWARDS FINANCIAL DEFAULT

¶1. (SBU) Summary. Despite numerous pledges to the contrary, the Government of Pakistan's (GOP) borrowing from the State Bank of Pakistan (SBP) is at a record high in spite of commitments to reduce borrowing to net zero levels in every quarter. While the Federal Board of Revenue has performed reasonably well in tax collection, surpassing targets by a small margin, funds are insufficient to finance increased spending. Although complete first quarter fiscal data has not been publicly released yet, the increased SBP borrowing indicates that the fiscal deficit could be much higher than targeted. The rapid depletion of foreign exchange reserves has created additional stress such as a large rupee depreciation and a liquidity crunch in the inter-bank market. The inter-bank call money rates have shot up to record levels and the State Bank of Pakistan had to intervene in the market to provide liquidity to banks. End Summary.

BORROWING FROM STATE BANK OF PAKISTAN AT RECORD HIGH

¶12. (SBU) GOP borrowing rose over 100 percent in the first 11 weeks of the current fiscal year (July 2008-June 2009). According to SBP data, the government borrowed PKR 170.19 billion (USD 2.16 billion) from July 1 to September 20 from the SBP. The GOP retired PKR 3.73 billion (USD 47.4 million) to the SBP during the same period last year. In the recent plan, "Economic Program of Pakistan: Reinvigorating Hope and Ameliorating Peoples' Livelihood" dated September 20, Ministry of Finance officials predicted a "likely over-run" in the first quarter budget deficit target; however, these GOP predictions called for an overrun of only 0.3 percent of GDP in fiscal deficit. With an overall budgetary fiscal deficit target of 4.7 percent of GDP for the current fiscal year, the GOP has exceeded all predictions with this estimated 1.47 percent of GDP budgetary deficit in just the first quarter, which is much higher than the quarterly fiscal deficit target of 1.17 percent.

¶13. (SBU) Analysts said that the government borrowing increased due to the large underlying budget deficit which includes debt-servicing, and a backlog of payments and subsidies. Commercial banks were also feeling the liquidity crunch and were not participating in auctions of government securities. The government has time and again committed to bring quarterly net borrowing from the central bank to zero in order to control inflation running at over 25 percent.

¶14. (SBU) On October 6, the SBP injected PKR 53.9 billion (USD 685 million) into the banking system to save it from the extreme credit

crunch and high call money rates. The first work day after the official three day EID holiday opened with a severe shortage of liquidity which pushed up inter-bank call money rates to 32 to 40 percent. The situation could have been worse if the SBP had not injected huge liquidity, PKR 53.9 million (USD 685 million), into the system. However, several local press reports quote commercial bank officials who claim that bank withdrawals during Ramadan and EID were much more than the amount injected by the SBP.

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RUPEE DEPRECIATION AT ALL TIME HIGH AND FOREIGN RESERVES FURTHER DECLINE
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15. (SBU) On October 6, the value of the rupee sank to a record low as import payments drove the rupee to a low of 78.65 against the dollar in early trades. The previous low was observed on Sept 22 at 78.55. Local currency dealers anticipate further depreciation due to impending import payments. Foreign exchange reserves with the SBP fell to USD 4.76 billion on October 6th from USD 4.86 billion on September 30th. The deposit of the recent USD 500 million Asian Development Bank loan is reflected in the marginal improvement of foreign exchange reserves, which were USD 4.68 billion on September 27th before the disbursement.

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TAX REVENUES ARE UP
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16. (SBU) Tax revenue is up 23.5 percent during the first quarter (July-Sept) of FY 09 over the same period last year. Showing 23.5

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percent increase, the Federal Board of Revenue raised PKR 253.3 billion (USD 3.22 billion) in the first quarter versus PKR 205.13 billion (USD 2.61 billion) in the same period last year. The revenue collection also surpassed the PKR 250 billion (USD 3.17 billion) target set for this quarter (July-September 2008). Domestic sales tax collection increased by more than 50 percent showing that the record inflation has helped the government to raise more revenue from consumers. Additionally, sales tax collection on imported goods grew by 17.1 percent, indicating that the newly imposed 30 to 35 percent additional customs duties on "luxury goods" has not slowed import growth as expected. Overall, imports surged by 31 percent year on year in July-August 2008 mainly due to increased imports of petroleum products as energy blackouts continue to plague the country and more generators are installed nationwide.

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COMMENT
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17. (SBU) Pakistan's economy has recently felt only negatives including a rapid depletion of its foreign exchange reserves, large depreciation of its currency and substantial slowdown in foreign inflows. As the GOP shops for assistance around the world, commitments to stem borrowing from the State Bank of Pakistan and to keep net borrowing at zero in every quarter of FY 09, have been a constant mantra. However, record borrowing from the SBP in the first quarter of the new fiscal year dampens expectations that the new government's economic reform plan is feasible and that the GOP has the discipline to implement the strict but necessary measures.

PATTERSON